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The Private Family Foundation: Causa Mortis

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THE PRIVATE FAMILY FOUNDATION: CAUSA MORTIS

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The foundation is a phenomenon which has 'come of age' since 1950. There was a time when a man's status in his community was determined by the number of cars in his garage. Now, his position in the community is based on the number of foundations under his wing. . . . The general public has only, in the past two years, become aware of what is actually taking place. . . . I predict that an informed public will make tax exempt foundations one of the most important issues of our time.[1]

If tax laws were graven on stone tablets, Rule One would deal with form and substance, and would warn of the peril in neglecting one for the other. Often transactions or events are designed by taxpayers to meet the form prescribed for tax minimization, but, unless substance is also contained, the planned tax consequences may not materialize. A frequent government challenge to minimization or avoidance techniques of taxpayers is that the real or first purpose of a plan does not coincide with its projected form.[2] Thus taxation, to give effect to reality, must exalt substance over form.[3] Congress, however, sometimes indulges, as do taxpayers, in exalting form over substance for its own purposes. Although tax bills have the form which suggests they are revenue-raising measures, and their substantive complexity is frequently commensurate with the increasing complexity of our society, in a *trompe l'oeil* tax laws are also used by the Congress to accomplish economic, social, penal, and sometimes political goals, which are important exceptions to the revenue-raising function. For example, the provisions dealing with enactment, suspension, restoration and repeal of the investment credit accomplished the needed economic goals;[4] the provision giving credit for state unemployment tax against federal unemployment tax[5] accomplishes important social goals; the

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1 Hearings Pursuant to H.R. Res. 13 Before Subcomm. No. 1 of the Select Comm. on Small Business, 88th Cong., 2d Sess. 1 (1964) (remarks of Representative Patman).

2 Knetsch v. United States, 364 U.S. 361 (1960).

3 National Investors Corp. v. Hoey, 144 F.2d 466 (2d Cir. 1944).

4 Int. Rev. Code of 1954, §§ 38-49.

5 Int. Rev. Code of 1954, § 3302.

excise taxes on marijuana[6] and alcohol[7] demonstrate penal goals; and, apart from the new foundation provisions, the treatment of segregated schools in the South under the exemption and contribution provisions satisfies political goals.[8] Both political and penal goals were involved in the reformation of controls over foundations, and these provisions, including the new Chapter 42 of the Internal Revenue Code, are the most complex tax legislation with non-tax or non-revenue motivation ever enacted.

Periodically, particular foundations,[9] or foundations as a class, have been the object of congressional concern. More often than not, the desire for rectification of alleged abuses was satisfied administratively, with exemption rulings being challenged or public statements being made to curb transactions.[10] In the case of small foundations, revocation of exemption generally ended the issue since the amounts involved were relatively small and the costs in submitting the case to judicial review were far greater than any possible benefits. This administrative rectification route presumed that the Internal Revenue Service was willing and able to make the effort to oversee exempt organizations. However, it has been suggested by one prominent member of Congress that the Internal Revenue Service's effort in controlling or scrutinizing foundations was completely inadequate.[11]

In 1968, the Congress required, to the extent possible, the Execu-

6 Int. Rev. Code of 1954, §§ 4741-776.

7 Int. Rev. Code of 1954, §§ 5001-692.

8 IRS News Release, July 10, 1970, 1970 C.C.H. Std. Fed. Tax Rptr. ¶ 6790.

9 Int. Rev. Code of 1954, § 509(a) defines "private foundation."

10 In recent weeks, the Jerry Rubin Fund was declared tax exempt to the dismay of some Congressmen. The IRS promised to review its ruling. See Washington Post, Sept. 4, 1970, at A-3. Better evidence of larger administrative action against a class of foundations was the wholesale IRS investigation of the Americans Building Constitutionally plan for converting doctors' and dentists' practices into tax exempt foundations. Hearings on Tax Exempt Foundations and Their Impact on Small Business Before Subcomm. of the Select Comm. on Small Business, 90th Cong., 1st Sess., at 235, 262-66 (1968) (remarks of IRS Commissioner Cohen).

11 Representative Patman has roundly criticized IRS efforts in watchdogging foundations and other exempt organizations: "Our findings show that the Internal Revenue Service Record—in terms of supervision of foundations—is a dud, a dismal failure." Hearings on Tax Exempt Foundations and Charitable Trusts Before the House Comm. on Small Business, 88th Cong., 2nd Sess., at ix (1963) (remarks of Representative Patman). For a complete survey of Mr. Patman's reports and activities, see Hearings on Tax Exempt Foundations and Charitable Trusts: Their Impact on Our Economy, Chairman's Report to the Select Comm. on Small Business, 87th Cong., 1st Sess. (1962); Subcomm. Chairman's Report to Subcomm. No. 1, 2d inst. 88th Cong., 1st Sess. (1963); 3rd inst., 88th Cong., 2nd Sess. (1964); 4th inst., 89th Cong., 2nd Sess. (1966); 5th inst., 90th Cong., 1st Sess. (1967); 6th inst., 90th Cong., 2nd Sess. (1968); 7th inst., 91st Cong., 1st Sess. (1969); see also Hearings Before Subcomm. No. 1 on Foundations, Select Comm. on Small Business, 88th Cong., 2nd Sess. (1964), n. 1, as continued, 90th Cong., 1st Sess. (1967). See also Hearings on the Subject of Tax Reform, Before the Comm. on Ways and Means, 91st Cong., 1st Sess., pt. 1, at 12-78 (1969).

tive Department to provide detailed proposals for tax reform.[12] The Treasury Department of the Johnson Administration turned over its work product to the Treasury Department of the Nixon Administration, which released such items on February 5, 1969.[13] Shortly thereafter, hearings on that subject by the House Ways and Means Committee were begun. In the forefront for reform were private foundations and taxation of unrelated business income. As a strictly revenue matter, neither of these prospective reforms were significant. As is the case in many areas of alleged abuse of the revenue laws by exempt organizations, the actual dollar loss is either conjectural or so modest, in relation to other important tax problems, as to cause one to wonder over the magnitude of concern generated.[14]

The full effect of the Tax Reform Act's changes can be analyzed in the three important aspects of foundation life. Phase One is the funding of the foundation, that is, the means by which it obtains its support from the donors, or the method by which it earns income to carry out its exempt function. Phase Two deals principally with the donor involvement conduct of its financial and related affairs including, in this sense, its investment program. Phase Three deals with the administrative or housekeeping responsibilities which generally attend the maintenance of this type of entity. This article will try to pull together the major changes made in the Internal Revenue Code affecting each of these three phases of the life of the smaller foundations, and how, taken individually or collectively, these changes signal the decline and eventual demise of the private family foundation.[15]

It is appropriate to focus on the smaller foundations since they represent the bulk of the foundations extant. The Treasury Department believes there are approximately 22,000 private foundations

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12 P.L. 91-172, 91st Cong., 1st Sess. (1969).

13 Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means, 91st Cong., 1st Sess., pt. 14, at 5047 (1969).

14 The revenue estimates as to "Foundations" appear to be based solely on the investment income tax and not on any other tax imposed by new Ch. 42 of the Int. Rev. Code. See generally 113 Cong. Rec. 13041-3048 (daily ed. Dec. 23, 1969). As originally proposed by the House, the foundation income tax was to yield from $65 million (1970) to $100 million (1979), H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 1, 160 (1969); as modified by the Senate Finance Comm., $40 million (1970) to $55 million (1979), S. Rep. No. 91-552, 91st Cong., 1st Sess. 20 (1969); as further modified by the Senate, $20 million (1970) to $30 million (1979), 113 Cong. Rec. 16056-6059 (daily ed. Dec. 8, 1969); and as agreed to in conference, $35 million (1970) to $55 million (1979), 113 Cong. Rec. 13044 (daily ed. Dec. 23, 1969).

15 Had the Senate Finance Comm. prevailed, foundations would only be entitled to live forty years. Compare S. Rep. No. 91-552, 91st Cong., 1st Sess. 25-27 with 113 Cong. Rec. 15729-5737 (daily ed. Dec. 4, 1969) and 113 Cong. Rec. 15753-5760 (daily ed. Dec. 5, 1969).

whose assets approximate 20 billion dollars in market value.[16] One congressional study based on 1967 computations showed that 647 foundations (and not the 647 largest foundations) had approximately $17.8 billion in assets.[17] Thus, about $2.2 billion was left for approximately 21,300 foundations, or an average of $100,000 in assets. Other sources show approximately 6,800 foundations with assets of over $200,000, of which the 236 largest had a market value of assets approximating $15 billion.[18] Thus, if 647 foundations had assets of $17.8 billion, there would be about 6,150 foundations with more than $200,000 in assets, or a total of at least $1.2 billion. Combining both asset figures, you may have no more than $1 billion left for 15,000 foundations, or an average of less than $70,000 per foundation. Although these are rather rough estimates, one can surmise that the principal impact of the new provisions will fall upon family foundations which probably are so small in size that only part-time management is available to conduct their affairs.

I. Phase One—Funding and Deductions

> The combined effect, in the case of charitable gifts of appreciated property, of not taxing the appreciation and at the same time allowing a charitable contributions deduction for the appreciation is to produce tax benefits significantly greater than those available with respect to cash contributions. . . . In some cases it actually is possible for a taxpayer to realize a greater after-tax profit by making a gift of appreciated property than by selling the property, paying the tax on the gain, and keeping the proceeds.[19]

A. *Charitable Contributions*

The combination of factors which stifle the creation of new foundations and the continuation of existing smaller foundations should begin with the limitations on inter vivos giving. The inducement for creating or maintaining a family foundation was to obtain a tax benefit for gifts of various classes of property (including stock or other securities) at appropriate times, thereby minimizing the burden of federal income or estate tax upon the donor and his family. Appreciated property, either securities or personal property, could be

[16] Hearings on H.R. 13270 Before the Senate Comm. on Finance, 91st Cong., 1st Sess., pt. 1, at 709 [hereinafter cited as Senate Tax Reform Act Hearings].

[17] Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means, 91st Cong., 1st Sess., app. I to pt. 1, at 5693 (1969).

[18] Calkins, The Role of Philanthropic Foundations, 11 J. of Philanthropic Foundations 5 (1969) citing J. Lewis, The Foundation Directory (3rd ed. 1967).

[19] H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 1, 53 (1969).

disposed of by gifts to one's newly created foundation during a high-income year. Low-basis, high-value securities, works of art, automobiles, boats, miscellaneous remainder interests in property, and other deductible tangibles or intangibles could be used to create a fund for the purported public weal with little real dislocation of a donor's income or asset status.

The Tax Reform Act limits the charitable deductions available for contributions of property, whether or not given to a foundation, and consequently checks many of the more blatant abuses in foundation giving. At the outset, a deduction is no longer available for the value of appreciation inherent in ordinary income property.[20] If an individual or corporation decides to donate inventory to any charity, the deduction available to the donor is the property's basis since the value of the gift is reduced by the amount of gain which would not have been long-term capital gain had the property been sold by the taxpayer at its fair value. Under prior law,[21] the allowance of a deduction for appreciation in ordinary income property, particularly in the case of business inventory, was of much benefit to business corporations or proprietors in control of foundations. Although the inventory of a business seemed an unlikely asset for a foundation or for any charity, it was a fruitful technique used by planners where the inventory had substantially appreciated in value over its cost. For example, a stockbroker, holding short-term securities in a rising market, was able to minimize his personal tax burden by dropping these securities into his foundation near the end of the year. A typical supplementary technique would be to have a buy-back arrangement for a unilaterally contrived price, and to trade in or out of the various securities to the broker's benefit. The mere availability of the foundation as a donee, through immediate control by the donor, assured that the stock would be taken regardless of time (e.g., December 31), amount or character of the investment. In the instance of the company-controlled foundation, inventory or fully depreciated property, such as office machines, typewriters and similar equipment could find a ready donee which would compliantly accept such goods and assure a contribution deduction, after reduction for depreciation taken.

In totality of effect, ordinary income property contributions, for the high-bracket taxpayer, frequently had the effect of providing such a person a greater benefit through a "contribution" than would be achieved had the property been sold and the proceeds retained. For example, if a taxpayer in the 70 percent marginal rate bracket[22] sells

[20] Int. Rev. Code of 1954, § 170(e).

[21] Prior to amendment, § 170(a) of Int. Rev. Code of 1954 allowed "any charitable deduction."

[22] The marginal rate is the amount paid on the last dollar of adjusted gross

section 306 stock[23] worth \$100 (basis \$50), the net effect gives him \$65 (\$50 profit × 70% rate = \$35 tax). Upon making a complete gift to his foundation, thereby keeping a measure of control over the stock, the individual saves himself \$70 in taxes, since he is allowed a \$100 deduction off the top of the income. This is an amount which returns his basis, \$50, the net profit after any sale, \$15, plus an additional \$5. The Internal Revenue Service sought to curb this obvious bonus in foundation giving by attacking the exempt status of the foundation-purchaser-donee, but without success.[24] By presently limiting the deductibility of ordinary income property to a taxpayer's basis, many of the marginal foundations will lose a source of support since there is no incentive to donate ordinary income property through this technique.[25] A bargain sale to the foundation at the taxpayer's basis (sales price equals basis) magnified the saving by providing him with \$85 in hand, as contrasted with \$65 had the property been sold. The \$50 derived from a bargain sale plus the \$35 tax savings from the \$50 contribution (\$50 × 70% rate) provides this realization. Under prior law, the seller-donor was allowed to treat his entire basis as allocated to the sale portion of the sale-gift.[26] If his selling price was equal to his basis, there was no taxable income. Today, under section 1011(b),[27] basis is allocated to the sale at the ratio which the amount realized (selling price) bears to the fair value of the property. Thus, if the donor sold a capital asset worth \$100 (basis of \$50) for \$50 to his foundation, only 50 percent of the basis of the property would be allocated to the sale. This would mean he has income of \$25 subject to a capital gains tax. In prior years, the sale-gift would have been tax free so long as the selling price was equal to or below basis. This new

income. The effective rate, on the other hand, is the percentage of all income paid in taxes.

23 Section 306 stock is stock issued as a dividend to a shareholder, and if any part of such dividend was not included in the distributee's gross income, the general rule treats the amount realized as ordinary income rather than capital gain to the selling shareholder. The provision was enacted to thwart shareholders who were attempting to bail out ordinary income from their corporations at capital gain rates by declaring stock dividends and then selling or redeeming the stock. Cf. Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), cert. denied, 347 U.S. 918 (1954). See generally B. Bittker and J. Eustice, Federal Income Taxation of Corporations and Shareholders 326-37 (2d ed. 1967).

24 William Waller, 39 T.C. 756 (1963), acq., 1963-2 Cum. Bull. 5.

25 Int. Rev. Code of 1954, § 170(e)(1)(A).

26 Prior to the 1969 Tax Reform Act, bargain sales to charity were allowed under Treas. Reg. 1.1001-1(e) (1957).

27 Int. Rev. Code of 1954, § 1011(b),

> Bargain Sale to a Charitable Organization—If a deduction is allowed under § 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property.

provision applies to any sale to a charitable organization including foundations where a contribution would be allowable. It was regarded as such a valuable donative technique that the Senate deleted the provisions during its consideration of the tax reform bill, but the provision was restored in conference.[28]

Most family foundations are regarded as "feeders" with no actual charitable functions.[29] Since they were not directly performing a charitable function, little use could be made of assets which were not income producing unless such assets were sold and the proceeds distributed. However, for personal property in the hands of taxpayers, other than intangible property, the foundation represented a vehicle for the quiet repose and protection of such property with attendent financial benefits through deductions. In many cases, no real benefit was provided any functioning charity, and the true beneficiary was the donor rather than the donee. Exploiting these areas of imaginative giving was fairly routine, and government investigators seemed concerned only in those cases where the property of the foundation continued to be used by the donor. Although the Service argued that personal use of the contributed property was contrary to the basis for exemption or was a prohibited transaction under section 503,[30] the deductibility of the value of such property remained unaffected.[31] If use of the asset occurred in a year subsequent to the year of the contribution, then there would be no adverse effect upon deductibility in the year of the contribution. However, under the new law,[32] the amount of any deduction for tangible property contributed to a foundation is reduced by 50 percent (62-½% in the case of a corporation) of the amount of gain which would have been long-term capital gain had the property been sold by the donor, if the use of such property by the donee is unrelated to the purpose or function constituting the basis for its exemption. Since the ordinary family foundation has no operational function, it will be rather difficult for a donor to establish that a painting, boat or car which he wants to give to his foundation has a use which relates to the function of the foundation.

If an item of tangible personal property has substantially appre-

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28 Compare S. Rep. No. 91-552, 91st Cong., 1st Sess. 471 (1969) with H.R. Rep. No. 91-782, 91st Cong., 1st Sess. 36 (1969).

29 This term is also used in Int. Rev. Code of 1954, § 502 to describe organizations which are operated at a profit but which pay all such profits to tax exempt organizations.

30 Int. Rev. Code of 1954, § 503, prior to amendment, provided generally for loss of the charitable exemption if the organization engaged in certain prohibited transactions. These prohibited transactions were expanded by the Tax Reform Act.

31 Rev. Rul. 67-149, 1967-1 Cum. Bull. 133, superceding I.T. 1945, III-1 Cum. Bull. 273 (1924).

32 Int. Rev. Code of 1954, § 170(e)(1)(B)(i).

ciated, and if the deduction is an important part of the prospective donor's tax planning, the worry over allowance of the full deduction will have a deterrent effect on the prospect of such contributions to family foundations. To give a work of art to an art museum seemingly assures a full deduction, except for the problem of valuation,[83] so that this type of property will end up with operating charities rather than private foundations. Even if the donor planned on having the foundation sell such property as a fund raising device, part of the deduction is lost.[84]

B. *Ford Reorganization*

Death now seems to be a significant consideration in planning for a foundation endowment. In prior years, a donor could contribute stock in his family enterprise with the assurance of a full deduction for the value of the amount contributed,[85] knowing that over the years he would be able to build up a sizeable monument under his name in his foundation. One of these types of transactions which several Tax Reform Act provisions affect is the so-called Ford reorganization. In this tax planning technique, a business enterprise is reorganized to provide a substantial amount of non-voting common or preferred stock to the shareholders who controlled the corporation prior to its reorganization. Putatively, the non-voting stock would represent more than half of the value of the business corporation, with the common voting stock representing the remaining value of the company. After the reorganization, the individuals in control of the corporation remain in control, but, in addition, they have the non-voting stock available to them for their use and disposition. Thus, as a lifetime planning tool and as an estate plannng tool, non-voting stock could be used to minimize the income or estate tax burden of the individuals in control of the corporation. This would be done, of course, by a contribution of the non-voting stock to a family foundation either over a period of years or at death, or both. If the contribution is made at death, it substantially reduces the federal estate tax burden on the owner of the corporation because a major portion of the value of his company would be going to charity. By direction of the gift through non-voting stock, the estate would receive a deduction for the "value" of the stock, and the decedent's heirs would continue to control the business enterprise, operated in the same fashion as before, and derive their benefits through the payment of salaries and

[83] For the conditions needed in deducting an art gift see Rev. Rule 57-293, 1957-2 Cum. Bull. 153.

[84] 113 Cong. Rec. 13038 (daily ed. Dec. 23, 1969).

[85] Of course the amount of contribution per year would be subject to the percentage limitation in Int. Rev. Code of 1954, § 170(b).

other forms of compensation. By contributing the shares to a private family foundation, the shares are never out of the sight or control of the individuals in control of the company. It may never be necessary, therefore, to redeem such shares or otherwise deplete the resources of the company, and control over the company remains intact.[86]

The government had been unable or unwilling to attack this funding device administratively. The existence of an unproductive asset, including shares of non-voting stock, never seemed to vitiate the exempt purpose or function of the family foundation. The only means attempted by the government to frustrate this transaction was to allege that the stock contributed had no value, but this line of attack was not upheld by the courts.[87]

The Tax Reform Act attacked this technique whether accomplished by gifts or bequests. At the inter vivos stage, the creation of an endowment in a family foundation through the use of company stock is almost prohibitive unless the desire for endowment overcomes the desire for tax deduction, a rather unlikely event. If a lifetime donor of appreciated property desires to have his foundation retain the securities as a form of endowment beyond the 15th day of the third month after the close of the year in which the gift is received, the donor will lose 50 percent of the amount of his deduction which would have represented long-term capital gain had the property been sold.[88] If the donor was a corporation, for example, contributing stock of a subsidiary to a company foundation, then the reduction in the contribution would be 62-½ percent of the potential long-term capital gain. The effect of this provision is, in the case of stock in the family business, that a donor desirous of an endowment, but more desirous of a deduction, would be required to spend 100 percent of the value of the contribution within 75 days after the close of the year in which the property was contributed in order to receive the full deduction. Because of this limitation on the extent of any deduction for the appreciation element in property contributions, a private foundation will not be the recipient of property, such as securities, unless the donor decides to accept the penalty of losing one-half the amount of the deduction attributable to the appreciation. This is a severe price to pay for any contribution, and it is submitted that few families will be willing or able to pay for the privilege of creating a foundation endowment.

The provision on limiting the extent of a deduction for a charitable contribution of appreciated property to a foundation does not apply

86 S. Rep. No. 91-552, 91st Cong., 1st Sess. 38-39 (1969).
87 Henry Pullman, T.C. Memo 1964-218.
88 Int. Rev. Code of 1954, § 170(e)(1)(B)(ii).

where the contribution was made by a decedent. The full value of the appreciation inherent in such property is deductible in computing the federal estate tax.[39] There is no requirement that, to obtain the deduction, a private foundation pay out the appreciated property within a specified period of time to enable the estate to receive a full deduction. In this sense then, some donors will be able to fund large foundations by making contributions of stock in their business enterprise which could not have been done due to the inter vivos limitations on giving. Control of the family enterprise through the foundation is disrupted, however, by a new provision in Chapter 42 of the Internal Revenue Code.

Under section 4943,[40] a private foundation can be taxed on an amount in any taxable year equal to 5 percent of the value of its "excess business holdings." The term "excess business holdings" means holdings of a private foundation in a business enterprise which are in excess of the "permitted holdings."[41] The term "permitted holdings" means 20 percent of the voting stock of a business enterprise reduced by the percentage of voting stock owned by all disqualified persons.[42] The allowable percentage of aggregate holdings for the foundation and all disqualified persons may reach 35 percent where it can be proved that a third person has effective control over the business enterprise.[43] This provision thus treats all non-voting stock as excess holdings except where all disqualified persons do not own more than 20 percent of the voting stock of that same business. Thus, in the example cited above, where the family retained all of the voting stock, none of the preferred stock would represent a permitted holding for a private foundation.[44] If a decedent contributes securities in his family business to a private foundation, and the family directly or indirectly owns more than the permissible 20 percent, the foundation would be treated as having excess business holdings upon receipt of the voting stock, presuming, of course, that some third party does not have effective control of the business. Thus, in those instances of bequests of voting stock or non-voting stock in a business which would be treated as excess business holdings, the foundation has only five years to dispose of the bequest tax free to other than the family.[45] Sale to persons outside the family,

[39] Int. Rev. Code of 1954, § 2055.

[40] Int. Rev. Code of 1954, § 4943.

[41] Int. Rev. Code of 1954, § 4943(c).

[42] Int. Rev. Code of 1954, § 4943(c)(2)(A). The term "disqualified person" generally means the foundation managers, substantial contributors to the foundation, corporations, trusts, partnerships, etc., in which they have a specified interest, and all family members except brothers and sisters.

[43] Int. Rev. Code of 1954, § 4943(c)(2)(B).

[44] H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 1, at 28 (1969).

[45] As noted infra, disqualified persons may not engage in any transaction such as

therefore, means it will eventually lose control of the business if the stock is given to the family foundation.

If the private foundation fails to dispose of the stock of the family business within the five-year period prescribed by the statute, it becomes taxable on the value of the stock. The initial tax on the excess holdings is 5 percent per year.[46] If the family and the managers of the foundation feel that they can hold on to the stock for several years and pay the 5 percent tax, the statute provides that the Internal Revenue Service can impose an additional tax of 200 percent of the value of the excess business holdings upon the foundation.[47] Likewise, under a special penalty provision for a "flagrant" act of, for example, retaining these holdings, the 5 percent or the 200 percent tax could be increased by the imposition of a special 100 percent penalty.[48]

It seems unlikely that a businessman would contribute stock in his business to his family foundation knowing that the foundation will be required to dispose of that property within five years to persons other than members of his family or the business itself. Although section 4943 does not specifically impose this limitation on dispositions, the transaction would be treated as a self-dealing act between the family member who purchased the stock and the foundation, thereby personally subjecting the family member to tax on the transaction. This problem is more fully discussed below.[49]

C. *Foundation Distributions*

Many individuals may decide that the disincentives to the creation or funding of a family foundation are not significant enough for it to discontinue its operations, and may finance their foundations through cash contributions or depreciated securities in order to carry on some charitable or like purpose of importance to the family. But for those persons who are more concerned that their charity provide them with a deduction than with the satisfaction of the philanthropy itself, the reformation of the extent of the deductions to foundations is indeed significant. Given, however, the understanding of a donor that he is willing to do his foundation charity without much in the way of personal tax benefits, there is the additional consideration of the dispensing of charity by the foundation.

sales or exchanges with their foundation; otherwise they are treated as self dealers and subject to tax. The exception for sales of excess business holdings back to the family by the foundation (Tax Reform Act, § 101(1)(2)(B)) applies only to holdings of the foundation owned on May 26, 1969.

46 Int. Rev. Code of 1954, § 4943(a)(1).

47 Int. Rev. Code of 1954, § 4943(b).

48 Int. Rev. Code of 1954, § 6684.

49 See p. 443 infra.

Another new provision, section 4945,[50] dealing with "taxable expenditures," will have the effect of making most family foundations mere conduits for contributions to publicly supported organizations. This section imposes upon a foundation an initial tax of 10 percent of the amount of the "taxable expenditure."[51] "Taxable expenditures" include amounts which a foundation pays or incurs (1) to make a grant to an individual for travel, study or similar purposes, or (2) to make a grant to an organization other than an organization described in § 509(a)(1), (2) or (3) (i.e., publicly supported organizations), or (3) for any purpose other than an exempt purpose.[52] If a foundation makes a grant to an individual, it can avoid the tax by establishing an objective and nondiscriminatory procedure, keeping appropriate records and obtaining IRS approval.[53] For a grant to an organization that is not publicly supported, the foundation must exercise "expenditure responsibility," a form of oversight over the grantee, and make and file appropriate reports on each such grant.[54] Even with the exceptions, the general import for the smaller family foundation is that there is incentive to channel the funds of the foundation only to established, publicly-supported institutions.

Safety may become the most significant consideration in the grant function unless foundation management is prepared to pay for legal advice on new organizations, non-public exempt grantees or individual grantees. For example, if a grant is made to a donee organization other than one described in section 509(a)(1), (2) or (3),[55] necessitating exercise of expenditure responsibility over the grant, the directors or trustees of the foundation must exert reasonable efforts and establish adequate procedures to see that the grant is spent solely for the purpose for which it was made, must obtain full and complete reports from the grantee on how the funds are spent, and finally must make full and detailed reports with respect to such expenditures to the Internal Revenue Service. It is likely that such responsibility is more than most families will be willing to assume with respect to the conduct of the affairs of the foundation, with the result that they will make their

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[50] Int. Rev. Code of 1954, § 4945.

[51] Int. Rev. Code of 1954, § 4945(a)(1).

[52] Int. Rev. Code of 1954, § 4945(d)(3),(g) (grants to individuals) and § 4945(d)(4),(h) (grants to organizations). Taxable expenditures also include amounts paid or incurred in connection with voter registration drives (Int. Rev. Code of 1954, § 4945(d)(2),(f) and legislative activity (Int. Rev. Code of 1954, § 4945(d)(1),(e)). As to the limitations on foundation political activity, see Note, Political Activity and Tax Exempt Organizations Before and After the Tax Reform Act of 1969, 38 Geo. Wash. L. Rev. 1114 (1970). See also Lehrfeld, The Taxation of Ideology, 19 Cath. U. of Am. L. Rev. 54 (1969).

[53] Int. Rev. Code of 1954, § 4945(g). See also T.D. 7022, 35 Fed. Reg. 763 (1970).

[54] Int. Rev. Code of 1954, § 4945(h).

[55] See note 9 supra.

distributions to more established institutions such as schools, churches or hospitals, avoiding innovation or experimentation. It seems likely that if the safest and most efficient means of carrying out private foundation activities is to make expenditures to publicly-supported charities, it will not take too long for the family to realize that this can be done directly, thereby avoiding the intervening device of the foundation, and avoiding certain limitations on contributions. Desirable of maintaining minimum exposure to this particular provision, and recognizing the greater tax benefits accorded direct contributions to public charities, the consequence of such realization will probably be manifested by termination of the small foundation.

II. Phase Two—Donor Involvement

> Self dealing is not of sufficient importance to justify federal legislation; it is submitted that self regulation by private foundations is the answer to this problem.[56]

Investigations by Representative Patman into the dealings of foundations and their financial transactions with donors, friends of donors, members of the family, etc., provided the necessary impetus to the Treasury Department to analyze foundation activities and suggest a bar on self-dealing transactions between particularly described individuals and private foundations.[57] Under Section 503 of the Code,[58] until its amendment, private foundations could not engage in certain specified prohibited transactions. For the most part, however, arm's-length dealings with donors and family members could be transacted without jeopardizing deductibility of contributions to the foundation or its exempt status. If there was no real detriment or loss to the foundation in these transactions, but the benefits flowing to the donor or the family were rather substantial, the government sometimes attempted to argue that the organization was not "exclusively" operated for charitable or like purposes. Tax exempt status for various family funds, however, was continued although assistance was furnished needy relatives,[59] old family servants,[60] or employees of the donor's corporation,[61] or the donor himself was able to borrow back some of his contributions.[62] Given the problems of "fair dealing" and

[56] Statement of Nat'l Assn. of Foundations, Inc., Written Statements By Interested Individuals and Organizations on Treasury Report on Private Foundations, Submitted to House Comm. on Ways and Means, 89th Cong., 1st Sess. 412 (1965).
[57] See note 11 supra.
[58] Int. Rev. Code of 1954, § 503.
[59] Otto T. Mallery, 40 B.T.A. 778 (1938), nonacq., 1939-2 Cum. Bull. 57.
[60] Havemeyer v. Commissioner, 98 F.2d 706 (2d Cir. 1938).
[61] Harnson v. Barker Annuity Fund, 90 F.2d 286 (7th Cir. 1937).
[62] Donald G. Griswold, 39 T.C. 620 (1962)), acq., 1965-1 Cum. Bull. 4.

the weighing of the benefits conferred in relation to benefits granted, tax exemption for the foundation and contribution deductions for the donor were generally sustained.[63]

One of the major problems of foundation use and abuse was that the only penalty available to remedy the alleged abuse was directed at the foundation for the year of the alleged abuse and, in addition, tied *possibly*, but not necessarily, to disallowance of a contribution deduction to the donor.[64] Unless the abuse of the income or assets of the foundation occurred in the same year as the year of a contribution, the family was generally unaffected, and it is hard to justify any sanction which is not imposed on the advantaged party to the transaction. The 1969 amendments overcame these limitations of section 503 by shifting the focus of the sanction and the scope of the proscribed activities. Section 4941[65] removes private foundations from the operation of section 503 and moves to prohibit self-dealing transactions by imposing an initial excise tax at a 5 percent rate and an additional tax at a 200 percent rate on the amount involved in the self-dealing transaction, on the self dealer and, under certain circumstances, the foundation manager. Self dealers are "disqualified persons,"[66] which includes a substantial contributor to the foundation, the foundation's management, and family members of the foregoing (except for brothers and sisters). Persons who are neither substantial contributors nor foundation managers may still be regarded as disqualified persons if they have certain actual or beneficial interests in a substantial contributor, for example, a corporation, trust or partnership. There is, then, both upstream and downstream attribution so as to taint corporations, partnerships, trusts or estates substantially related to any of these persons. Attribution can operate three, four or five times removed so as to treat an individual as a disqualified person even though his relationship to the private foundation is relatively remote. For example, if corporation *A*, equally owned by three brothers, made a substantial contribution to a foundation, each brother would be regarded as a disqualified person. The spouse of each brother would likewise be regarded as a disqualified person along with the children of such individuals. If a child of one of the owners of corporation *A* owned corporation *B*, corporation *B* would also be treated as a disqualified person in relation to the private foundation. If corporation *B* happens to sell stationery to the foundation, it would be liable for a tax on the value of the supplies sold to the foundation. Most importantly, it would be liable for the tax notwithstanding its lack of knowledge that it was a disqualified person in relation to the

63 Id.
64 Int. Rev. Code of 1954, § 503(d) prior to amendment by 1969 Tax Reform Act.
65 Int. Rev. Code of 1954, § 4941.
66 Int. Rev. Code of 1954, § 4946.

foundation, or its lack of willfulness with respect to engaging in the self-dealing transaction.[67]

The transactions which are potentially taxable to a disqualified person include the sale, exchange or leasing of properties between the foundation and any disqualified person. This includes, for example, the transfer of indebted real or personal property (by contribution) to a private foundation where the disqualified person placed a mortgage or similar lien on the property within ten years ending on the date of transfer.[68] The lending of money or other extension of credit between a foundation and the disqualified person is a self-dealing transaction, unless the money loaned to the foundation is without interest or other charge, and the proceeds of the loan are used by the private foundation exclusively for purposes described in section 501(c)(3).[69] The furnishing of goods, services or facilities by a disqualified person is a self-dealing transaction unless it is without charge to the foundation, and the goods, services or facilities so furnished are used exclusively for purposes described in section 501(c)(3). If goods, services or facilities are furnished by a foundation to a disqualified person, they must be furnished on a basis no more favorable than that available to any member of the general public. Thus, a foundation can furnish an office without charge to a foundation manager, but no better an office than what would be furnished any individual holding the same position. A corollary to this provision taxes compensation paid to disqualified persons unless the amount of compensation is reasonable and the services are necessary to carry out the exempt purpose of the foundation.[70] Finally, there is the catch-all provision which taxes a self dealer where there has been a transfer to, or use of, by him or for his benefit, any part of the income or corpus of the foundation.[71]

The initial tax on the self dealer is 5 percent of the amount involved with respect to the self-dealing transaction. The amount involved represents the greater of the amount of money or fair market value of the property given or received with respect to the self-dealing transaction.[72] The tax is imposed for each year in the taxable period in which the transaction remains outstanding and uncorrected.[73] Thus, if the transaction continues over a period of years, the 5 percent tax is imposed upon the self dealer on an annual basis until the transaction is reversed. If the Internal Revenue Service discovers the transaction,

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[67] The self-dealing tax will apply to "inadvertent" transactions, H.R. Rep. 91-413, 91st Cong., 1st Sess. 215 (1969).

[68] Int. Rev. Code of 1954, § 4941(d)(2)(A).

[69] Int. Rev. Code of 1954, § 4941(d)(1)(B).

[70] Int. Rev. Code of 1954, § 4941(d)(1)(D), (d)(2)(E).

[71] Int. Rev. Code of 1954, § 4941(d)(1)(E).

[72] Int. Rev. Code of 1954, § 4941(e)(2).

[73] Int. Rev. Code of 1954, § 4941(a)(1), (e)(1).

notifies the disqualified person of the existence of it, and demands the correction of the transaction, the failure of the self dealer to correct the transaction may lead to a tax equal to 200 percent of the amount involved. In any case in which the transaction represents a repeated type of transaction, or in a single case where the self dealing was flagrant, a 100 percent penalty can be imposed with respect to the initial tax, or the additional tax, or both. The effect of this, in the aggregate, means that a member of the family which engages in a transaction with a private foundation can end up paying to the federal government more than four times the value of property or other items involved in the self-dealing transaction.

Few people try to justify or condone self dealing in the crasser sense where fair value is not given and received by the parties. However, some persons may feel that dealing with their foundation should not be a hazardous avocation, since many benefits may accrue to the foundation, and ultimately all charity, through various transactions between a family and its foundation.[74] But the provision was not meant to preserve the baby and throw out the bath water. Its purpose was single and complete: ban all self dealing by personally taxing those individuals involved so that no measure need be made by administrators to determine or quantify the benefits conferred or burdens sustained. Thus, by disregarding the balancing process, shifting the sanction to the individuals involved, and having the sanction apply absolutely, regardless of knowledge, negligence, willfulness or the like, the family or other disqualified persons of the foundation would channel their investment and other opportunities elsewhere to the long-term benefit of public philanthropy.

III. Phase Three—Administrative and Housekeeping

> [To require a public foundation report] will restrain a staff of a foundation that might be a little overanxious to do things because they know that what they are going to do will have to be disclosed. By that I do not mean doing things in the sense of something dishonest, but I mean in the way of extreme social action of some kind.[75]

Every family foundation must have a board of directors or trustees and officers who take the responsibility for determining the size, shape and locus of grants, writing out the checks, filing the annual report with the state, maintaining the books and records on grants, and otherwise acting as a form of "management." At the present time, these management officials may act rather discontinuously with little, if any,

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74 Senate Tax Reform Hearings at 5499-511.

75 113 Cong. Rec. S 15647 (daily ed. Dec. 4, 1969) (remarks of Senator Curtis).

formalities observed, even for a part-time paid staff. However, foundation managers acting in such haphazard fashion are the potential targets of several of the taxes prescribed in Chapter 42. This means that the failure to devote full time and attention to the responsibilities of managing a private foundation may cost a director, trustee, officer, employee, or other person his own money. Initially, a foundation manager is liable for 2-½ percent tax on the amount involved in a self-dealing transaction if he knew he was engaging in a self-dealing act and did so willfully and without reasonable cause.[76] In addition, if there is a refusal on his part to agree to correction of all or part of the self-dealing transactions, the manager could be subject to an additional tax of 50 percent of the amount involved, subject to a $10,000 limit as to either tax.[77] In the investment area, a manager who knowingly participated in the investment of income or assets of the foundation in a manner which jeopardized its ability, through speculative trading, to carry out its exempt function, could be taxed at the rate of 5 percent of the amount so invested if he did so willfully and without reasonable cause.[78] Failure to correct the hazardous investment renders the manager liable for a 5 percent additional tax on the amount involved, subject again to a $5,000 maximum for the initial tax and a $10,000 maximum for the additional tax.[79] Finally, in the case of a foundation manager who agreed to make any "taxable expenditure,"[80] he is liable for 2-½ percent tax on the amount involved unless his agreement was not willful and due to reasonable cause.[81] This means, for example, that if the foundation manager fails to exercise expenditure responsibility over a grant to another private foundation, he may be taxed personally at the rate of 2-½ percent of the amount of the grant. If foundation management refused to agree to all or part of the correction of the taxable expenditure, it could be liable for a tax of 50 percent of the amount of taxable expenditure, up to the $5,000 and $10,000 limits.[82]

Who among the family is willing to risk this hazardous duty merely to satisfy some other family member's desires for personal philanthropy? To any other individual, even a lawyer or accountant aware of his Chapter 42 exposure to the substantive provisions, the mere existence of such exposure may be enough to render that person unavailable for a management position. There is no particular appeal

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[76] Int. Rev. Code of 1954, § 4941(c)(2).
[77] Int. Rev. Code of 1954, § 4941(b)(2), (c)(2).
[78] Int. Rev. Code of 1954, § 4944(a)(2).
[79] Int. Rev. Code of 1954, § 4944(b)(2), (d)(2).
[80] Int. Rev. Code of 1954, § 4945(d)(2).
[81] Int. Rev. Code of 1954, § 4945(a)(2).
[82] Int. Rev. Code of 1954, § 4945(b)(2), (c)(2).

to being a non-professional foundation manager, since one would not be able to devote full time and attention to the foundation and assure non-liability as to his management of its affairs. Part-time foundation managers would also be discouraged when reckoning with new record-keeping and reporting responsibilities which attend the administration of foundation affairs, since there are personal penalties, both civil and criminal, for failure to carry out these duties.[83]

Complaints about foundation secrecy as to income, assets, grants, salaries, and the like were rectified by provisions in the Tax Reform Act which require additional administrative responsibilities.[84] Previously, a foundation was only required to file with the Internal Revenue Service an exempt organizational information return.[85] An annual report is now required of every private foundation, in addition to the information return which had at least $5,000 in assets at any time during the year. What is important about the annual report is that among the responsibilities which attend its preparation and submission to the Internal Revenue Service, the foundation must place a notice of availability of the annual report in a newspaper having circulation in the county in which the foundation's principal office is located. The notice must state the address of the foundation's principal office, the name of its principal manager, and the fact that the report is available for inspection during the regular business hours by any citizen who requests it.[86] This means, for example, that the businessman who keeps the foundation's books and records in his home must open up his home to any citizen who desires to inspect the records of

83 Int. Rev. Code of 1954, §§ 4944(a)(2), 4945(a)(2), (b)(2), 6685.

84 Under Int. Rev. Code of 1954, §§ 6033(b), 6055(b), the accounting and other responsibilities which now attend foundation management require information on total contributions and gifts received during the year; the names and addresses of all substantial contributors; the gross income of the foundation for the year; the expenses attributable to such gross income which were incurred within the year; the disbursement (including administrative expenses) paid or incurred within the year; disbursements within the year for purposes for which the foundation maintains its exempt status; an itemized list of all grants made or approved for future payment during the year showing the amount of each grant, the name and address of the recipient, and the relationship between any individual recipient and the foundation, managers or substantial contributors, and a record of the purpose for each grant; financial information in the nature of a balance sheet showing assets, liabilities and net worth; an itemized statement of the foundation's securities and all other assets as of the close of the year, with information on both the book and market value; the names and addresses of all the foundation managers; the names and addresses of highly compensated employees; the compensation and other payments (e.g., expense accounts) made during the year to each foundation manager; the compensation and other payments made during the year to highly compensated employees; the address of the principal office of the foundation and, if different, the place where its books and records are maintained; and finally, the information regarding transactions which fall within the ambit of Ch. 42 of the Code.

85 IRS Form 990-A.

86 113 Cong. Rec. 15646-5647 (daily ed. Dec. 4, 1969).

the foundation. Failure to maintain or make available these records renders the manager liable for personal penalties.[87]

A private foundation manager is also liable for personal penalties for failure to file either a timely or a complete annual report with respect to the information required. The annual report penalties are imposed upon the foundation manager or other person (possibly including an outside accountant or attorney) who is under a duty to perform the act in respect of which a violation occurs.[88] Failure to file, through either negligence or willfulness, a timely annual report, as contrasted with a timely information return, may render the foundation manager liable for a $10 a day penalty (subject to a $5,000 maximum) unless reasonable cause was shown for such failure. No advance notice to management as to its failures is required of the Internal Revenue Service before the assessment of the penalty is made.[89] For the foundation manager who *willfully* fails to file a timely annual report, *willfully* fails to publish notice of the availability of the timely report in a newspaper, or *willfully* fails to comply with the public inspection requirements, there is the prospect of a $1,000 fine with respect to each such failure.[90] Finally, if a foundation manager who is required to furnish the information on foundation activities willfully furnishes fraudulent information to the Internal Revenue Service, the manager is subject to a $1,000 fine or one year in prison or both.[91] As a consequence, the maintenance, availability and correctness of books and records is singularly important.

No longer may it be assumed that the management of a small foundation (except one below $5,000 in assets) may be carried on in haphazard fashion. The obligations for administration and recordkeeping, timely filing and overseeing of the investment, charitable and housekeeping functions require the family and the manager to pay closer attention to foundation affairs than to their personal affairs. If the wife can't balance her checkbook or forgets to write down certain checks for personal bills, there is no problem. If, however, that syndrome is carried over to the family foundation, the results could be disastrous.

Conclusion

To a donor unconcerned with the tax considerations, or at least willing to accept the disincentives to foundation giving, the private

87 Int. Rev. Code of 1954, § 6685, provides for a $1,000 fine for each willful failure to file the report or to fail to comply with the publicity requirements of § 6104(d).

88 Int. Rev. Code of 1954, § 6652(d)(3).

89 Id. Under § 6652(d)(2) notice is required for assessment of the penalty in the case of late filing of an organization's information return.

90 Int. Rev. Code of 1954, § 6685.

91 Int. Rev. Code of 1954, § 7207.

foundation may represent an appropriate, but unlikely, vehicle for the personal touch in philanthropy. Assuming his managers, not necessarily including himself, are well versed in the tax law and are good record keepers, his foundation can concentrate on areas of direct and immediate charitable consequence relevant to the donor's personal ideology or philanthropic goals. But with the new law, the exploration of social or economic actions by funding studies or direct action groups will be severely constricted. The Treasury Department Report on Private Foundations portrayed the pre-Tax Reform Act role of foundations in these terms:

> Private philanthropy plays a special and vital role in our society. Beyond providing for areas into which government cannot or should not advance (such as religion), private philanthropic organizations can be uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly.
>
> Private foundations have an important part in this work available even to those of relatively restricted means, they enable individuals or small groups to establish these charitable endeavors and to express their own bents, concerns, and experience. In so doing, they enrich the pluralism of our social order. Equally important, because their funds are frequently free of commitment to specific operating programs, they can shift the focus of their interests and their financial support from one charitable area to another. They can, hence, constitute a powerful instrument for evolution, growth and improvement in the shape and direction of charity.[92]

It is submitted that this is no longer the case for the threat of sanction is, and will be, as devitalizing an act as the actual application of any tax upon a foundation. The true toll of the foundation provisions will not be in the amount of Chapter 42 taxes collected, but rather in the unmade grants for unusual or experimental educational, charitable and scientific projects.

In sum, the personal and organizational risks which today inhere in the operation of a private foundation are substantial. The disincentives to creation and funding of a new foundation are enormous,

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[92] Treasury Department Report on Private Foundations, Senate Comm. on Finance (1965).

and the advantages to be gained over public philanthropy have disappeared. Indeed, the lawyer who creates a "Mom and Dad" or small family foundation in this climate displays the same kind of judgment he had when he bought his second Edsel.

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